

**Report No. 32346-BY**

# **Belarus: Window of Opportunity to Enhance Competitiveness and Sustain Economic Growth**

*Country Economic Memorandum for the Republic of Belarus*

## **EXECUTIVE SUMMARY**

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**Poverty Reduction and Economic Management Unit  
Europe and Central Asia Region**



**Document of the World Bank**

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## EXECUTIVE SUMMARY

1. This Country Economic Memorandum (CEM) for the Republic of Belarus takes stock of the growth trends in the country's economy since 1996, reviews the evidence of the accumulated challenges and risks within the existing growth patterns, and provides recommendations aimed at strengthening growth sustainability. In sum, while economic growth in the last nine years has been impressive, the report argues that maintaining the current growth strategy would lead to a gradual erosion of economic competitiveness. The government should make significant policy adjustments by reorienting its policies toward ensuring a better business environment and a smaller size of government.

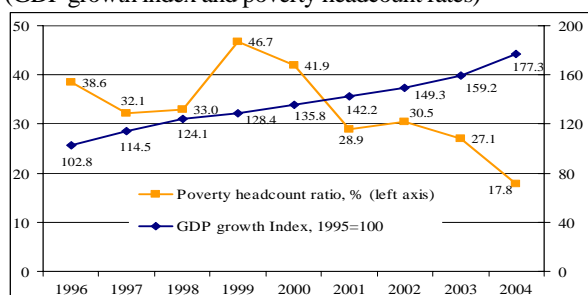
2. The current international and domestic environment is favorable for supporting a policy shift toward the acceleration of structural reforms. At the moment, the government is well equipped to mitigate the potential costs of these reforms because the policy settings are largely determined by the growing economy, the positive trends in both the enterprise and the household sectors, favorable developments in the global economy, low debt, and the strong administrative capacity of the state. This situation could change: various pressures might become stronger, and then the same reforms would become politically more costly and fiscally more risky. In short, the current window of opportunity should be used to ensure that the authorities' growth and poverty objectives are sustainable in the medium to long terms.

### SUMMARY OF GROWTH AND REFORM PROGRESS

3. **The Belarusian economy has experienced steady and sizable growth since 1996.** In 1996-2004 overall GDP growth averaged 6.6 percent per annum or 77.4 percent cumulatively. It has been driven primarily by improvements in labor productivity and increases in both energy efficiency and capacity utilization. Fiscal and external adjustments were significant and helped to enhance the macroeconomic conditions for growth.

4. **Economic growth has been fairly broad-based.** In contrast to some other CIS countries, the patterns of growth in Belarus have been much more beneficial for labor. Strong growth in the labor-intensive sectors (such as services, food processing and machinery), backed by government wage and income policies, helped to ensure that the benefits from recent growth were broadly shared by the population. Growth in labor earnings amounted to about 53 percent of total GDP growth over 1996-2003. Poverty rates declined substantially, while inequality remained rather stable and moderate. The poverty headcount ratio (national definition) was more than halved -- from 38.6 percent of the population in 1996 to 17.8 percent in 2004, which meant that about 2 million people moved out of poverty (Figure E1).

**Figure E1: Steady Growth Has Driven Poverty Reduction, 1996-2004**  
(GDP growth index and poverty headcount rates)



Note: The poverty headcount ratio is defined as the percentage of the population below the national poverty line.

Source: MSA.

**5. Since 2000, the government's policies have gradually been adjusted and distortions have been reduced.** Despite various remaining problems, the latest growth episode has been based on improved incentives for investment and restructuring at the enterprise level. The main directions of improvement undertaken during this period were as follows:

- Improved macro policies, such as a unified exchange rate, stricter monetary policy, considerable fiscal and quasi-fiscal adjustment, and lower inflation
- An energy and utility policy aimed at full-cost recovery in tariffs, strict payment discipline, and advancements in energy efficiency
- The phasing out of barter, which inter alia helped to accelerate export diversification out of the Russian market.

**6. At the same time, since the late 1990s, Belarus has succeeded in sustaining and even improving the performance of its energy sector.** This was an important factor in advancing macroeconomic stabilization. The investments in the sector were sufficient to maintain sector assets in a satisfactory condition and carry out modernization projects, which contributed to improved energy efficiency. The incidence of both quasi-fiscal subsidies and deficit declined, and this improved the financial viability of energy companies. Moreover, the centralized sector structure and the preservation of the command and control governance mechanisms helped the sector to survive the economic crises that affected many FSU countries and their respective energy sectors in the second half of the 1990s.

**7. This growth has taken place despite uneven macroeconomic progress and the slow and inconsistent progress in structural reforms.** Belarus has managed to maintain moderate budget deficits and debt levels. However, inflation has remained significantly higher than in other transition economies. The current account position is still precarious, given the low level of reserves, the inability to attract a sizable amount of FDI, and the limited access to international financing. Overall, there are serious macroeconomic risks associated with continuing the current growth strategy, especially in relation to its balance of payments situation and export concentration (Box E1). Belarus lags behind most of the transition economies in various aspects of post-socialist transformation. The government reacted to the economic declines of the early transition by introducing policies aimed at strengthening its role in the economy. According to the EBRD, Belarus showed the least amount of progress among all transition economies in such reform areas as enterprise restructuring, large-scale privatization, and infrastructure reform. For example, in a number of fundamental dimensions of reform in the energy sector Belarus lags behind almost all of the other FSU countries, which have recently moved more decisively toward private sector involvement in the energy sector, and have also enhanced their institutional framework to make it more transparent and accountable.

**8. These developments leave the Belarus experience somewhat at odds with the standard transition paradigm,** and the relative stability of the Belarusian economy has been called a “puzzle.” In contrast to the situation in other better performing transition economies, nine years of growth in Belarus have not been backed by sound and consistent macroeconomic policies, advanced structural and institutional reforms, and a thriving private sector. In fact, the Belarusian economy now has a number of features that make it very different from most transition economies. These include: (i) the dominance of traditional firms (state-owned or quasi-private) in production and exports; (ii) the high degree of government intervention in enterprise operations (covering both SOEs and privatized firms), including the preservation of some elements of central government planning of output, wages, and employment; (iii) the high level of the tax burden and the major budget redistribution of funds

aimed at supporting traditional firms and employment; and (iv) the high dependence on trade with Russia and the slow pace of the geographic diversification of exports.

**Box E1: Main Macroeconomic Risks of the Current Growth Strategy**

**Low international reserves** (0.6 months of imports) in the context of no access to international capital markets poses the risk of a disorderly balance of payments adjustment (through either the depreciation or rationing of imports, or both) and potentially significant output costs.

**High dependence of non-oil product exports on a single and unstable export market such as Russia** that accounts for about half of total exports. To date, Belarusian enterprises have demonstrated only a limited capacity for export diversification.

**High concentration of the economy** further aggravates the above-mentioned risks. Both budget revenues and foreign exchange proceeds depend too much on the operations of a limited number of exporters, which in turn depend excessively on the business conditions in the one external market. The 100 largest taxpayers contributed about 30 percent of total tax proceeds.

**Large size of the government.** The tax burden (about 45 percent of GDP in 2003) is substantially higher than in neighboring countries. This puts Belarusian producers at a competitive disadvantage. At the same, an important part of the Belarusian growth success derives from the government's capacity to support expansion in domestic demand through budget instruments.

**Vulnerabilities in the banking sector** largely relate to the high incidence of directed lending (about a quarter of all commercial credit). Any erosion in the competitiveness of the real sector would lead to a rapid worsening in the share of non-performing loans, which would require government interventions to prop up the banks.

**Developments in the pension system represent a major fiscal risk.** The combination of demographic trends and government social policies generates significant fiscal pressures on the country's pension system, which is not capable of supporting this level of benefits in the future.

**The costs of adjustment to future higher prices of Russian energy** will be considerable. When measured against actual 2003 energy imports, they exceeded 6 percent of GDP a year.

GROWTH DRIVERS

9. **The growth analysis reveals two specific time intervals during which the Belarusian economy has relied on quite different growth models.** The first growth phase (1996-2000) is explained largely by the simultaneous effect of two groups of factors: (i) active political re-integration with Russia, which resulted in improved market access; and (ii) government policies that, through the real depreciation of the rubel and an expansion in the interest rate and other implicit subsidies, provided sizable net benefits for many leading exporters. The second growth phase (2000-04) has been driven by (i) a drastically improved external environment; (ii) a strengthened domestic demand; and (iii) the improved financial performance of domestic enterprises.

*The first growth phase: 1996-2000*

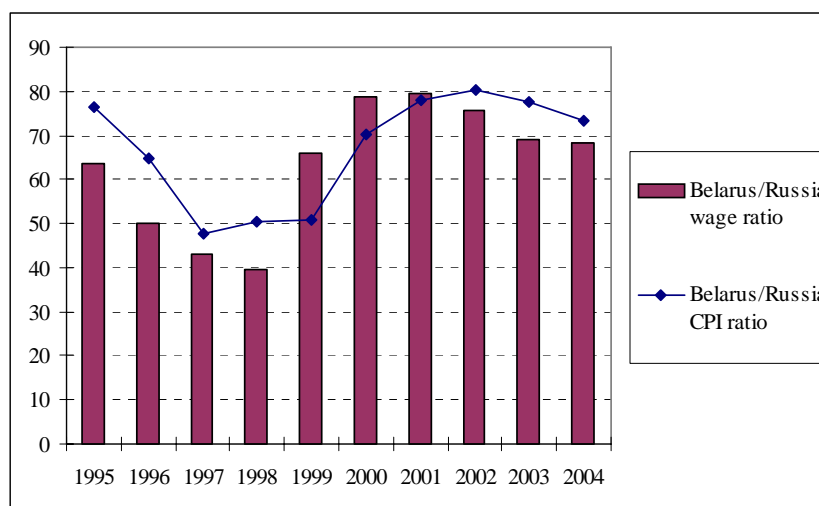
10. **The policy of re-integration with Russia was critical for the growth in the first phase.** Thanks to special relations with Russia, at the height of the output crisis in the CIS, Belarus was far better able to preserve its production capacity in manufacturing than any other CIS country (Russia included). The Union Treaty has already yielded important arrangements fostering mutual trade by, most important, setting up a functioning Customs Union that led practically to the abolishing of the mutual customs border. At the same time, the excessive export concentration on Russia reflects the

duality of Belarus' export capabilities – a considerable part of what is exported to Russia cannot be sold in other markets.

11. **While the government policy in the late 1990s was destabilizing, it created a considerable (albeit artificial and temporary) price advantage** for Belarusian producers relative to those in Russia (Figure E2). This price advantage appears to be fundamental to explaining Belarusian growth at that time. For the period 1996-99, the average price ratio for Belarusian and Russian markets was at about 60 percent of its level in both 1995 and 2000. However, this price advantage has been mostly driven by wage, not productivity, differences.

12. **The price advantage helped secure a considerable share of the large Russian market** and thus established a first-mover competitive advantage for Belarusian exporters. When Russia started to grow after the 1998 crisis, the Belarusian industry was well positioned to benefit from this growth. In the environment of the growing Russian market, it was easier (relative to exporters from other countries) for established Belarusian exporters to expand export volumes, primarily by improving capacity utilization. In other words, the scale of cost and market advantages accumulated before 2000 was sufficiently large to support further export growth to Russia in 2000-04.

**Figure E2: Significant Price Advantage of Belarus over Russia, 1995-2004**  
(Annual average relative prices and wages, Russia = 100%)



Source: Gotovsky and Zheltkov (2004).

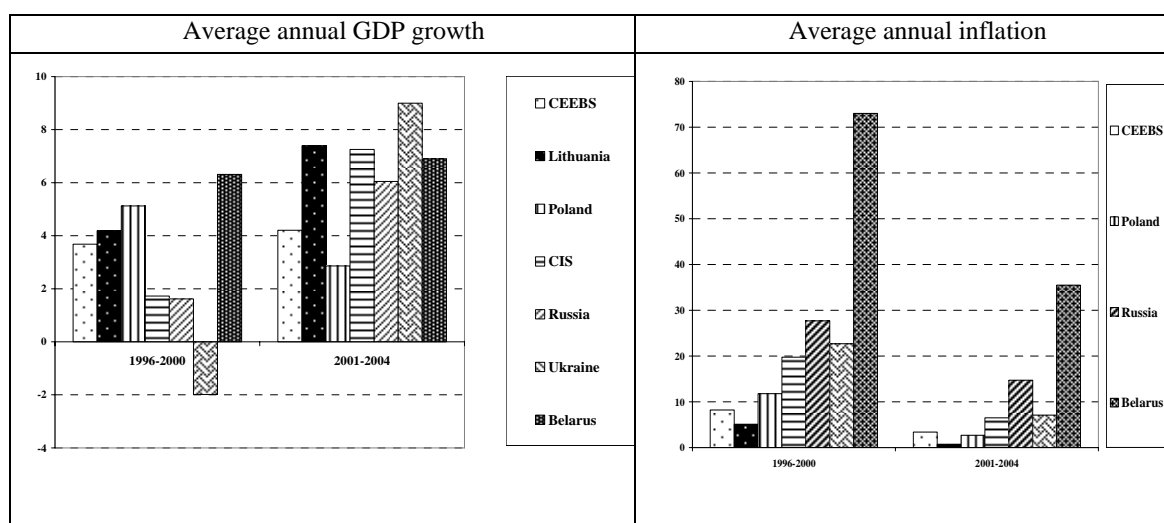
13. The effect of the above factors was significant largely because of the low capacity utilization in 1995. In the years of early growth, the average capacity utilization in industry grew rapidly, from 37 percent in 1995 to 53 percent in 1999.

*The second growth phase: 2001-04*

14. **During the more recent growth episode, the role of the initial growth drivers (privileged access to the Russian market, temporary cost advantages, and subsidies to exporters) has gradually been declining. However, new factors have emerged that have helped sustain growth, including the following:**

- **A drastically improved external environment.** This reflects primarily the rise in oil prices, which benefited Belarus directly (expansion in oil processing exports) and especially indirectly – accelerating Russian growth and Russian demand. This improvement also includes a number of secondary factors such as improved external prices for metals and fertilizers (both relatively important export items for Belarus) and the raising of the volume of Russian remittances. While recent economic growth in Belarus has been strong, it is worth noting that it is not extraordinary by regional standards. In fact, during the period 2001-04 the CIS as a group showed a stronger performance than Belarus, and the difference in growth rates between Belarus and Central European countries decreased (Figure E3).
- **A strengthening of the domestic demand.** The government budget and wage policies, based on excessive government involvement in the economy, became an important source of steadily rising domestic demand. Moreover, the existing trade regime helped to limit growth in consumer imports and to ensure that domestic producers, especially in the consumer sector, became the main beneficiaries of the growth in domestic demand.
- **The improved performance of domestic enterprises in selected sectors,** which was driven by competitive pressures in external markets and was facilitated by a certain amount of domestic macroeconomic stabilization and some strengthening of budget constraints. With all caveats, the Belarus industrial sector was able to generate significant growth in both productivity and exports.

**Figure E3: GDP Growth and Inflation in Various Transition Economies, 1996-2004 Period Averages (%)**



Source: World Bank ECA Regional Database.

15. **The Belarusian puzzle, it seems, has a conventional economic explanation** -- Belarus had, and still has, significant comparative advantages in its main export market, which is Russia. However, this poses a question that is central to this report: how stable are these advantages and how high is the risk that they may be eroded quickly?

16. **While recent economic growth has been strong, there are a number of indications that the existing growth model has reached its limitations** and cannot ensure growth sustainability without reform. These indications relate to chronic weaknesses in financial and investment

performance, the depressed level of new business entry, and especially the slow changes in Belarus' export patterns. The low dynamism of the country's exports represents the essence of the competitive challenges that Belarus is facing.

#### ANALYSIS OF ENTERPRISE PERFORMANCE

17. This report analyzes the Belarusian growth performance along three dimensions: (i) productivity trends, (ii) export dynamism, and (iii) enterprise restructuring in both industry and agriculture. Because of its industrial structure, trends in manufacturing competitiveness are critical determinants of the overall economic performance in Belarus. In a small open economy growth cannot be sustainable without strong and diversified export capabilities within an enterprise sector that is fully restructured to respond properly to market signals.

##### *Trends in industrial productivity and competitiveness*

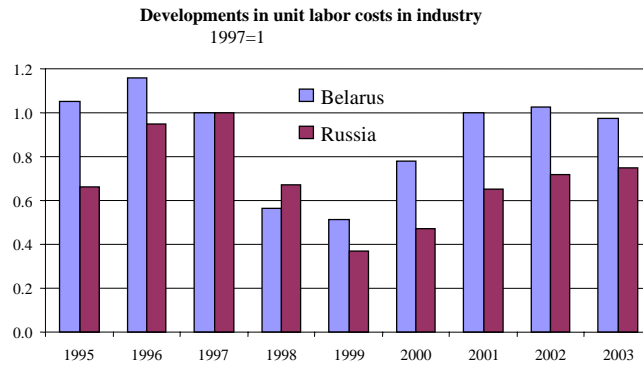
18. There have been four broad trends in industrial productivity during 1996-2003.

19. **First, Belarusian industry demonstrated a significant, steady, and broad improvement in productivity.** Labor productivity practically doubled during the period. All output growth in the sector derived from productivity improvements. The sub-sectors that faced the strongest external competition (machinery, construction materials, and apparel) became the leaders in productivity improvements in 1999-2003. They over-performed compared to the sectors that were more resource dependent (such as fuel, chemicals, and metals). In response to competitive pressures, the average restructuring effort within the Belarusian industry increased.

20. **Labor productivity improvements were supported by labor markets.** Despite the remaining administrative interference in enterprises' employment and wage decisions, there has been considerable room in the economy for labor mobility in response to market signals. Labor movement has generally moved from less productive to more productive sub-sectors, while the wage differential has been broadly consistent with the differences in sector productivity. There was also a major employment shift from agriculture to services, construction, and transport. Such employment restructuring had positive longer-term growth and poverty implications, since agriculture in the CIS tends to be a low-productivity, low-wage sector with large hidden unemployment. Since 1990, total employment in agriculture and forestry has declined by 40 percent.

21. **Second, the competitive advantage of Belarus is being eroded by high wage growth.** Average unit labor costs (ULC) grew strongly in 1999-2001, driven by both a policy of accelerated real wage growth and real currency appreciation, and remained broadly unchanged in 2001-03. Competitiveness would have eroded even further had it not been for the recent high productivity growth, which since 2001 has largely offset wage increases. When compared to 1997, relative labor costs in Belarusian industry in 2003 were at least 20 percent higher than in Russia (Figure E4). The deterioration of competitiveness relative to Russian producers was most noticeable in the food processing and construction materials sub-sectors. In fact, the actual deterioration of Belarus' competitive position has been even more significant if the recent substantial reduction in average payroll taxation rates in Russia is taken into account.

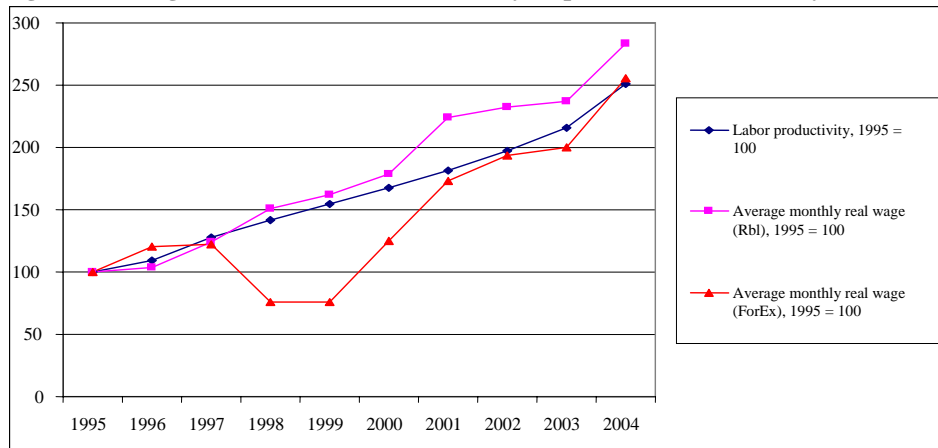
**Figure E4: Growth in Unit Labor Costs Indicates Erosion in Competitiveness, 1995-2003**



Source: World Bank staff estimates.

22. The evidence suggests that government wage policy has seriously undermined Belarusian competitiveness. For the period 1996-2001, real rubel wage growth consistently exceeded productivity improvements (Figure E5). These findings suggest that the continuation of the current policy of rapid wage growth will be more risky in the future relative to the earlier period, because a significant portion of the earlier cost advantage has eroded by now.

**Figure E5: Wage Growth Exceeds Productivity Improvements in Industry, 1995-2004**

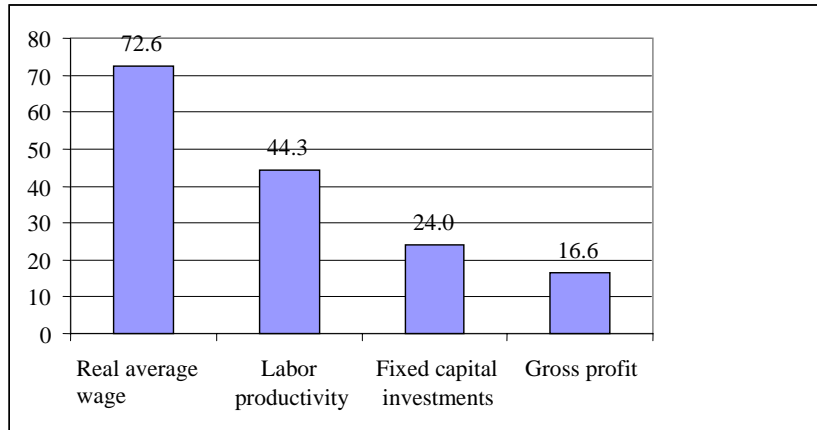


Source: World Bank staff estimates based on MSA data.

23. **Third, the analysis suggests a considerable mismatch in the growth of the main performance indicators at the micro level.** According to the 2004 industrial enterprise survey, growth in investments has recently been more widespread than growth in profits, confirming the gap between financial performance and investment performance (Figure E6). At the same time, the incidence of productivity growth by far outpaced the incidence of growth in investments but in turn has been less common than growth in wages. It is clear that the economy cannot sustain such a growth mismatch for an extended period because, in the long term, wage growth should be backed by adequate productivity improvements, which must be based on sufficient growth in investments and profits (to finance these investments).



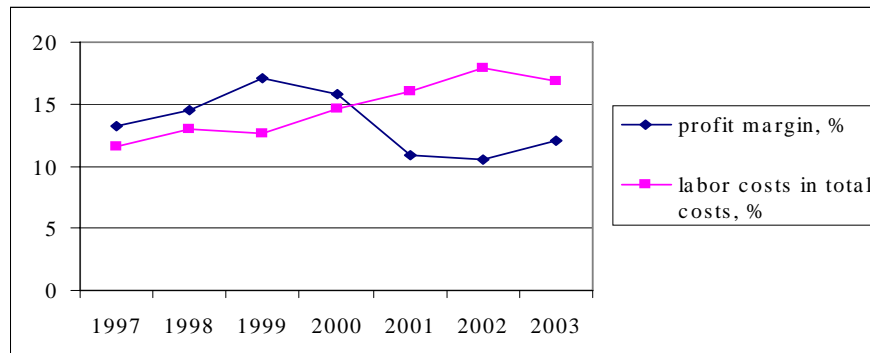
**Figure E6: Unbalanced Growth -- Managers' Answers about Recent Changes in the Performance of Their Enterprises (balance between those who reported an increase and a decline)**



Source: IPM (2004).

24. **Low profitability represents an important source of vulnerability for Belarusian industry and is driven primarily by excessive wage growth.** Low profitability is a basic indicator of low rate of return on investments, which, other factors being equal, drives down the investment attractiveness of the country. Financial performance (with average margins below 10 percent) is weakest in the sub-sectors that face stronger competitive pressures in both the domestic and CIS markets. About a quarter of industrial enterprises are loss-making. The share of total labor costs (wages and payroll taxes) in total production costs increased by more than 50 percent in 1997-2002. Figure E7 shows a clear negative correlation between changes in profitability and labor cost share.

**Figure E7: Growth in Labor Costs Drives down Profitability in Industry, 1997-2003**



Source: World Bank staff estimates based on MSA data.

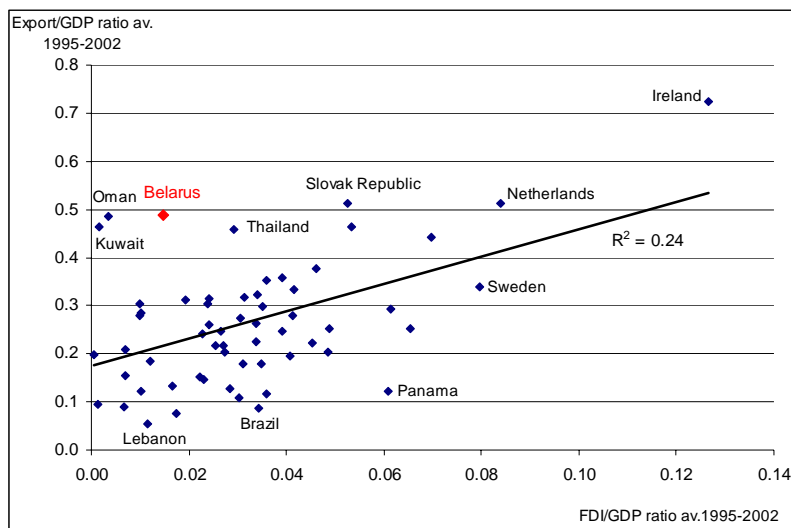
25. **Fourth, productivity growth is undermined by the low levels and low quality of investments.** This is primarily due to the weak investment climate. In particular, there seems to be a major incentive bottleneck as regards strengthening real sector investments in the environment of the prevailing state ownership in large enterprises (which are known worldwide for their propensity to under-invest) and the high costs of entry for the new private sector. The existing incentive framework for enterprise management is excessively focused on attaining short-term growth targets and

addressing the government's social priorities. This leaves too little financial room for investments and longer-term restructuring efforts.

26. **The weak investment climate led to a depressed level of FDI, which represents a serious disadvantage for Belarus.** The country's cumulative FDI per capita for the period 1989-2003 accounted for US\$ 200, which is on average about 10 times less than in the Central European countries. This not only reduces the overall level of investments in Belarus, but, more important, deprives the economy of major dynamic benefits. FDI usually helps to push up productivity in the host country by providing access to modern technology, management, and training. This access is particularly important for transition economies, where additional efforts are needed to bring the quality of production up to international standards.

27. Moreover, in the era of globalization, FDI volumes have become a primary determinant of a country's capacity for export growth (Figure E8). From this perspective Belarus is a significant outlier from the global trend -- its current level of export development is disproportionately high relative to the depressed FDI level. This disproportion suggests that without expansion in FDI inflows Belarus may find it difficult to expand its export on a sustainable basis.

**Figure E8: Export-FDI Interlink: A Global View, 1995-2002**



Source: World Bank staff estimates based on WDI.

28. **Investment financing remains extremely limited.** While enterprise self-funding is limited because of low profit margins, commercial credit is generally less accessible and more expensive than in the neighboring countries. Moreover, government interference in credit allocation places those firms that are unable to participate in the directed credit programs in an especially difficult situation. In addition, the analysis of cross-sectoral variations in performance suggests that government interventions create significant barriers for the efficient allocation of investment funds. In particular, there may exist a negative correlation between investment growth and profitability, indicating that less profitable sectors have been able to finance more investments.

29. **The tax burden is substantially higher in Belarus than in the neighboring countries,** which puts Belarusian producers at a competitive disadvantage. For example, in 2003 the total explicit tax burden in Belarus amounted to 44.7 percent of GDP as against 34.7 percent in Russia.

Moreover, the tax structure is highly distorted -- about 30 percent of all taxes paid by industry are turnover based. The manufacturing sector has been disproportionately affected by the current tax policy.

30. **Business perceptions as seen from the enterprise surveys, reflect a growing concern about declining competitiveness.** Overall, most survey respondents believe that their products are competitive domestically and to some extent in Russia. However, with respect to other markets, the balance of responses is either close to zero (which points to the absence of competitive advantage) or negative. Among the main determinants of their competitiveness, the respondents emphasized the role of cost factors, primarily those associated with low wages and low profit margins in Belarusian industry. However, the existing cost/price advantage appears to erode rather quickly, as can be seen by comparing responses from the similar 2004 and 2002 surveys. The leading factors in the potential cost disadvantage of Belarusian enterprises in Russia relate to the growing wage burden, higher taxation, and more expensive borrowing.

*Trade performance: low dynamism of export patterns*

31. **Strong export performance has been a distinctive feature of the recent growth episode.** As a small open economy, Belarus depends heavily on its export capabilities for its growth prospects. Backed by an improved demand in Russia and higher oil prices, the country's exports more than doubled in 2000-04. The contribution of the price factor to overall export growth has been significant recently: in 2001-04 about a third of total export growth was due to price movements. However, imports grew at a high rate as well, so that the trade deficit as a percent of GDP was relatively stable during 2000-03. The rise in imports in 2004 led to a sharp deterioration in the trade deficit to 9 percent of GDP.

32. **However, Belarus' exports remain highly concentrated in terms of export markets, exported products, and the role of leading exporters.** Russia's share, while somewhat decreased, still accounts for about half of the total exports and about 90 percent of the CIS exports. The 20 largest exporters are a source of more than 55 percent of all exports and more than 80 percent of non-CIS exports. Ten main export commodities accounted for over 50 percent of the total exports in 2004. These are the products that were traditionally produced and exported by Belarus before independence. This excessive export concentration leaves the country's trade vulnerable to external shocks.

33. **Trade restructuring and diversification is taking place at a much slower pace than in the neighboring countries.** While the share of the EU-15 in Belarusian exports has been growing (24 percent of total exports in 2004 as compared to 7 percent in 1998), it is still extremely low if one accounts for the country's location. Moreover, this recent expansion in exports to the EU has a very narrow base. It has been due primarily to a sharp increase in exports of processed oil products. Only a quarter of Belarusian industrial firms export outside of the CIS. This is comparable to the level observed in Russia in 1994 before any substantial restructuring had started.

34. **The export structure shows very limited dynamism.** In addition to the high concentration, the report's analysis revealed several serious weaknesses in the recent export patterns, which, if not addressed, pose a serious risk for future growth. The number of product groups in which Belarus exhibits strong export specialization is low and declined between 1998 and 2003. The factor intensity structure of exports shows an increasing importance of exports that are resource-intensive and unskilled labor-intensive. Reliance on such commodity groups generally limits the possibility of job generation and productivity improvements in the economy. Underdeveloped intra-industry trade with the EU reflects the failure to attract European FDI. This further limits opportunities for trade-related productivity gains.

35. **The survey data do not provide evidence that Belarusian exporters have been losing their traditional markets in Russia** (except for light industry – textiles, garments, and footwear). However, the data are troubling regarding the current level of competitiveness in Russia, especially in the food processing and machinery sub-sectors. This may be interpreted as a problem of further export expansion: export growth to Russia has been strong recently, but sustaining this rate of expansion could be difficult for exporters within the prevailing set of business conditions.

*Agriculture: strong growth that remains heavily subsidized*

36. **The performance of the agro-food sector, especially since 2000, is in many respects an excellent illustration of the “Belarus puzzle.”** Despite a somewhat uneven record, growth in agricultural output averaged about 6 percent in 2000-04. Improvements in the underlying performance have been considerable at many levels but especially in productivity and export. This has apparently been achieved without dismantling the key features of the former Soviet system of farm organization and control.

37. **The recent growth in the sector can be explained by a combination of exchange rate adjustments, a doubling of state support, and improvements in the “internal terms of trade.”** The household sector has been particularly dynamic and has contributed to the sector’s performance substantially ahead of its land resources. The analysis of productivity indicators vis-à-vis Russia has revealed that Belarusian producers have a competitive productivity advantage in all commodities except milk. The extent of this competitive advantage has, however, shrunk somewhat in recent years.

38. **State support to agriculture has grown substantially in recent years, and its scope is clearly unsustainable.** In 2000-04 it accounted for 10-12 percent of all consolidated budget expenditure and 3-4 percent of GDP. In 2004, state support per hectare was twice as high as in 2000. Compared to other CIS countries, Belarus has the highest level of budgetary support. However, it is much lower than the level of support in some transition economies in Central Europe.

39. **State support remains insufficiently transparent,** heavily affects the operations of the banking system, and favors the most inefficient agricultural enterprises. It compromises the stated government efforts to facilitate productivity growth in the sector. At the same time, prices remain highly distorted, with some prices effectively taxed and others heavily subsidized relative to international levels. The net effect of the government’s policy is a sector that is too costly for taxpayers and displays serious inefficiencies.

40. **The food processing sector reveals chronic underlying inefficiency,** despite some recent improvements. One major concern is its low capacity utilization, which is a critical determinant of processing efficiency. The sector requires a considerable consolidation of its excess capacity. In addition, its capital stock has been substantially eroded as revealed by the exceptionally high levels of depreciation. To date, the sector has been receiving essential support through the depressed prices in primary agriculture, which have helped to delay the necessary restructuring in processing.

41. **The only feasible way to sustain recent growth** in agriculture is to establish conditions that are supportive to growth in competitiveness and greater penetration of export markets. From a fiscal perspective, future growth cannot rely on further expansion of state subsidies. Moreover, future growth must become more export-oriented and at the same time less dependent on the Russian market. In the medium term, Belarusian agricultural producers will face more international competition, which will raise the requirements of their competitiveness level.

42. **The suggested sequencing of reform in the sector**, reflecting government's choice for a gradual pace of transformation, gives priority to the following steps: (i) price liberalization and the removal of input subsidies; (ii) more effective targeting of support toward efficient entities and enforcing a hard budget constraint, (iii) more decisive farm restructuring, and (iv) a more aggressive FDI policy targeted to upgrading the processing sector.

*Lagging enterprise restructuring*

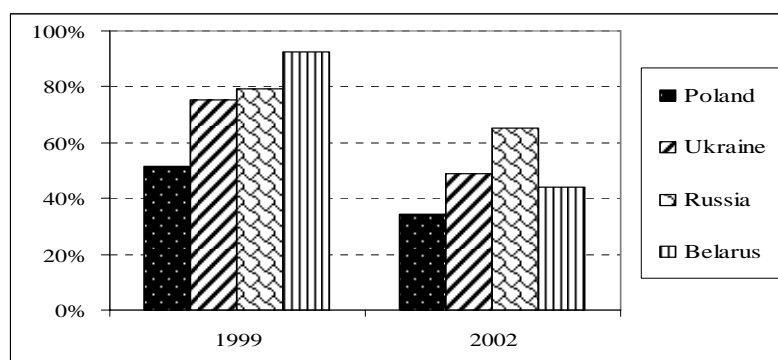
43. **Belarusian firms have made only limited progress in many of the key elements of enterprise restructuring**, such as asset restructuring, integration into the world economy through trade and investment, and the reorganization of companies to make them vibrant components of the market economy. This follows from a detailed analysis of the new enterprise survey, using the same models that have been employed with success in other transition economies, including Poland and Russia.

44. **The determinants of growth and other improvements in enterprise performance in Belarus are clearly different from those in other transition economies.** In particular, the following basic hypotheses on the impact of firm ownership on performance are rejected by the data: (i) privatized firms do not perform better than SOEs; and (ii) new firms for the most part are not found to perform differently from other firms, both SOEs and privatized firms. These results are the strongest indication that the institutional environment in Belarus has not yet taken a form that can advance the emergence of a dynamic market economy. The environment in which both de novo and privatized firms operate prevents them from realizing the potential benefits of private ownership. This relates to the uneven playing field, the restrictions on the operations of the product markets, credit rationing, weakness in the corporate governance regime, etc. Even in privatized firms, owners as a rule have difficulties replacing firm management. Overall, the private sector remains quite depressed: privatized firms are still affected by considerable government controls, while new private firms are mostly weak.

45. **The recent productivity growth in Belarusian industry appears to have a very limited foundation in improvements in economic fundamentals**, such as ownership change, entry of new firms, penetration of new markets, acquisition of new skills (such as new management), etc. Instead of introducing genuine restructuring in response to market signals (as was the case in other economies in transition), the industrial sector has largely been adapting to a combination of growing competitive pressures, an improved macroeconomic environment, and continued administrative controls. This adaptation has resulted in productivity improvements that stem primarily from better utilization of the inherited industrial capacity. However, the longer-term sustainability of such improvements is of concern.

46. **Increased domestic competition** with the new private sector and with imports is likely to be the leading driver of industrial restructuring within the Belarus economic model. BEEPS surveys have revealed a serious shift toward the acknowledgment of the importance of competition from imports in Belarus between 1999 and 2002. Interestingly, the magnitude of the changes in the perceptions of competitive pressures among Belarusian entrepreneurs was much stronger than in neighboring countries (Figure E9).

**Figure E9: Growing Sense of Competitive Pressures (Percent of firms calling competition from import not important or only slightly important in 1999 and 2002)**



Source: BEEPS database.

47. With all of these caveats, restructuring in industry, including SOEs, has indeed taken place and has resulted in some unbundling. The problem is that the overall restructuring was slow and limited, and some important (basic) restructuring measures are yet to be implemented. As this report argues, it may be increasingly difficult to accelerate restructuring in the future without making serious changes in the institutional and regulatory environment. If this is to be undertaken, the right set of incentives should be in place. This would be impossible without de-politicization – a missing element in the transformation of the industrial sector in Belarus to date.

48. **The analysis suggests that radical reform is urgently needed to free the growth potential associated with an entrepreneurial approach, entrepreneurial dynamism, and flexibility for new entry.** The transition experience identifies new firms as the engine of restructuring and growth, but Belarus deprives itself of this major economic benefit. In particular, various studies suggest that foreign firms could play a very important role in enterprise restructuring in transition.

#### ANALYSIS OF ECONOMIC POLICIES

49. In addition to an analysis of the macroeconomic environment, the report looks into other policies that are critical to sustaining competitiveness, such as the quality of the investment climate and the trade regime.

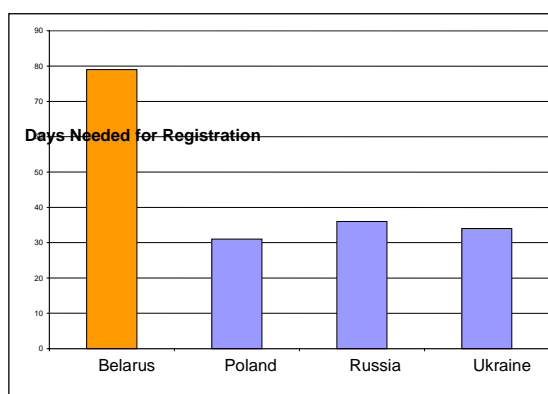
*The investment climate remains largely unsupportive to productivity growth*

50. **The continuing excessive government intervention in the activities of the enterprise sector crowds out the positive impact of the latest reforms.** Over the last few years the government has made some progress in simplifying business registration and licensing, as well as in regulating of export activities. The government is planning to continue streamlining and simplifying the processes for starting a business and is considering introducing a “one window” registration process to facilitate new market entry. However, these improvements have gone in tandem with the deterioration of the situation in other areas of the business environment. Belarusian business people have strong negative perceptions of the trends in the country’s investment climate. The survey results do not yet show any significant positive outcomes of what the government considers a substantial shift in its policy directions. Cross-country comparisons suggest that Belarus is a high cost place to do business, especially if one takes into account the implicit costs of delays related to the lengthy administrative procedures (Figure E10). The low rate of new business creation is a strong indication of the costly

business environment. As reflected in various international indices, Belarus' investment climate is perceived as one of the most hostile in Europe.

**51. The existing business environment represents a major risk for the sustainability of the country's economic growth.** It undermines Belarus' growth prospects through a number of channels. First, the high costs of compliance with administrative regulations mean that a significant amount of resources is diverted from more productive use. Second, the high costs of entry deprive the economy of major benefits associated with flexibility and innovation, which only new firms could generate. Third, the high incidence of government interference damages Belarus' investment image, poses the risk of international economic isolation, limits the country's opportunities for attracting FDI, and generally reduces the potential benefits of global integration which its neighbors enjoy.

**Figure E10: Business Registration Is Too Slow (days)**



Source: Database "Doing Business in 2005."

**52. The high costs of overregulation, regulatory uncertainty, and informality affect companies in their daily operations in a multitude of ways.** The greatest concerns of the business community relate to the following:

- Inspections are seen as the most severe administrative barrier and have been worsening over time. Unplanned tax inspections, non-tax fiscal inspections, and sanitary inspections are specifically highlighted as a major problem.
- The administration of business permits is lengthy and costly. This specifically hurts the investment process (land and construction permits, permits for the occupation of business premises).
- Tax administration aggravates the problems associated with the high tax burden because of the multitude of taxes, excessive tax inspections, the instability and complexity of tax legislation and the severe penalties for unintentional mistakes.
- Price controls remain excessive. The survey revealed that in 2002 a staggering 66 percent of firms had been affected by price and profit margin controls to some degree.

- Firing restrictions remain mostly informal, but enterprises are sensitive to their effect. Among large state-owned and privatized companies more than a quarter claims to have excessive staffing levels.

53. **Belarus should use the current favorable macroeconomic situation to launch reforms in the investment climate.** An important lesson from other experiences with transition is that fundamental improvements in the business environment cannot be attained quickly and solely through the introduction of a package of “good” regulations. Business environment reforms are of long-term nature. A considerable amount of political will to change the prevailing government attitudes to business and enhance public-private dialogue is needed, as well as a deeper reform of public administration, the civil service, and the judiciary. Many of these changes are easier to undertake in the environment of a stable and growing economy. Thus, Belarus should not miss its window of opportunity to advance these reforms without further delay.

54. **Belarus has an administrative advantage that could support its future reforms in the business environment.** An important asset of the Belarusian state is a relatively good capacity for the quick resolution of business disputes and a low level of corruption within state institutions. It also has a track record for resolving specific administrative problems that have proved difficult to address in other CIS countries. For example, the VAT refund was not seen as a problem by Belarusian exporters (in contrast to the view in the countries in the region). While traders complain about some deterioration in customs administration, customs clearance in Belarus is less time-consuming than in the neighboring countries.

55. At the same time, the analysis suggests that there may be a serious internal conflict between the government’s plans to reform the business environment and its reliance on the existing economic model for development. The current economic model requires massive administrative interventions at the micro level, which unavoidably raises the costs of doing business in the country and imposes serious limitations on the extent to which the business environment could be improved without dismantling some central components of the existing control system.

*Expensive subsidization undermines economic competition*

56. **The complicated and pervasive system of state support to the real sector is a fundamental feature of the Belarus economic model.** The government has been pursuing an activist industrial policy under which most large enterprises have been in a position to negotiate with the government a case-by-case package of incentives and benefits to support their rehabilitation and development programs. This has resulted in a system of state support that is too costly, too segmented and non-transparent, with too many programs and beneficiaries. In spite of various government attempts in recent years to streamline, quantify and access its effectiveness, little change has been achieved to date. The coexistence of a high nominal tax burden, massive tax benefits and subsidies for those enterprises that are either less efficient or well-connected undermines competition and the stimulus for productivity improvements.

57. **The aggregated measures of enterprise subsidization show no significant decline in the incidence of state subsidies in Belarus.** In 2001-04 the estimated annual net subsidy amounted on average to 6 percent of GDP. This is somewhat lower than it was before 2001, but is still excessively high. It is comparable with the total national public spending on education (6.3 percent of GDP in 2004). Agriculture remains the most heavily subsidized sector.

58. **The current system of support has an adverse impact on credit markets.** The total amount of credit allocated through direct government interventions (directed credit programs from the



banks, budget loans, and credits issued with government guarantees) in 2001-04 amounts on average to about a quarter of all annual commercial bank credit in the economy. This crowds out proper commercial credit and makes borrowing much more expensive for those who cannot participate in the government programs, including small private firms.

*Trade regime: the high incidence of non-tariff restrictions discourages trade*

59. **Belarus' trade regime is characterized by modest import tariff rates but rather extensive non-tariff barriers.** The average import tariff rates were stable and quite modest in 1998–2003, remaining between 10 and 14 percent. Agricultural import tariffs, with the exception of few commodities, do not seem excessively high. The fiscal importance of import taxation is quite modest, which provides a justification for the simplification of the import tariff schedule, which is currently overly segmented.

60. **A large number of ad hoc administrative restrictions on trade exist in Belarus on both the national and local levels.** These restrictions are primarily aimed at limiting the import of consumer goods, and they seem to succeed in keeping the share of consumer imports relatively low. This anti-import bias in the regulatory regime is reflected inter alia in additional permit requirements for specific types of consumer imports and higher rates of sales tax for imported goods relative to their domestically produced competitors. The government should undertake to review and to cleanse the large regulative array in order to liberalize trade. The existing customs procedures for control of customs value of imports, which de facto act as minimal prices on imports, contradict to the WTO Customs Valuation Agreement. This issue needs to be addressed on a priority basis.

61. **Recently, Belarus has made considerable progress in its WTO membership bid** by introducing a large mass of new WTO-compliant legislation. Progress was also made on several sectoral fronts such as agriculture, standards, and intellectual property rights. Nevertheless, much remains to be done. Given that no single bilateral market access agreement has been signed as yet, Belarus should be considered as a country at the early stage of accession, which could be compared to the situation of Russia and Ukraine three to five years ago. The experience of neighboring countries should caution the government against excessive optimism regarding the potential speed and ease of accession.

62. **Belarus' legislation on foreign investment and free economic zones is reasonably good.** However, it has not resulted in sizable foreign investment because of a detrimental economy-wide business environment.

*The benefits of economic and trade relations with Russia are large but are diminishing*

63. **The integration process with Russia has been important for Belarus in two fundamental ways.** First, Russia provided direct demand support for traditional Belarusian exports, including labor-intensive items in the machinery and equipment sector. Second, the integration process was a primary driver for recent policy adjustments, including several major reform steps such as the unification of the exchange rate and the phasing out of direct NBB financing of the budget deficit.

64. **Trade with Russia played a vital role in supporting Belarus' economy through a significant resource transfer.** The main channels of this transfer were discounted prices for Russian energy, non-market trade arrangements (such as barter and inter-government agreements on mutual direct deliveries), and unilateral violations by Belarus of the provisions of the Customs Union. The resource transfer from Russia has been significant throughout the post-Soviet period. Belarus and other CIS members continue to benefit from energy import prices that are much lower than their

world market equivalent, but this effect has been steadily declining. Moreover, Belarus, until recently, received better energy arrangements than the rest of the CIS. When compared to the prices of gas imports to Ukraine, in 2000-03 the average annual transfer received by Belarus through lower gas prices amounted to about 2 percent of GDP. However, these transfers have largely dried up from 2004 onward.

65. **Belarus used the rents associated with special relations with Russia strategically.** A large portion of these rents was centralized by the government and used for various public programs, including infrastructure investments, enterprise support, and social assistance throughout the economy.

66. **A potential erosion of the Belarusian comparative advantage in Russian markets, due to either unexpected political shifts or for economic reasons, represents a significant risk.** In particular, a major potential challenge may come from a future higher pace of restructuring in the Russian (mostly private) corporate sector relative to the restructuring rate that Belarusian SOEs could afford. In recent years there have been signs of increasing competitive pressures faced by Belarusian exports in the Russian market, as expressed in their declining market shares in total Russian consumption. On the import side, in the medium term Belarus will face the unavoidable costs of adjustments that relate to future higher prices for Russian gas and oil. The latter costs, as measured against actual 2003 energy prices and import volumes, exceeded 6 percent of GDP a year.

#### PRIORITY DIRECTIONS FOR REFORMS

67. **In the longer term, in aiming for sustained growth the authorities will need to make a determined push for a comprehensive reform program** to accelerate the country's transition to a market economy. These efforts should address a number of pending issues in all the core areas of liberalization, macroeconomic stabilization (including price and exchange rate stability), privatization, and wide-ranging structural reforms. Despite their up-front costs, the structural reforms (including public administration, legal and judicial, social assistance and insurance, and infrastructure reforms) represent a critical element in the sustainable growth strategy. This report recommends that the government use the current window of opportunity associated with the favorable external and internal economic environments, to accelerate the reform process without much delay.

68. **In the case of Belarus, the level of FDI attracted should be seen as an indicator that summarizes** the economy's longer-term potential to sustain growth and competitiveness. Belarus seriously underutilizes the advantages of its geographic location as a basis for attracting FDI and restructuring its trade patterns. Addressing this weakness should be a policy priority. FDI inflows would ease the financing constraint, facilitate technology transfer, and provide access to new product markets. Even if there are concerns about widespread foreign ownership, it should be borne in mind that liberalizing economies in the Far East, such as Vietnam, have generated considerable gains from channeling foreign investments through joint ventures.

69. **However, this report is focused primarily on a narrower set of key reform priorities,** which could be sufficiently advanced within the very gradualist approach toward market transformation explicitly chosen by the government. Many of the recommendations that follow are fully consistent with the objectives outlined in the various government development programs. These recommendations are intended to help the government address the immediate growth challenges, as identified by the report's analysis, which otherwise may pose a risk for the government policy targets in the areas of wage and employment growth and poverty reduction.

70. **The focus of the report's recommendations is on two inter-related challenges that the government must address in order to strengthen the competitiveness of the economy as a source of sustainable growth:**

- **Imposing stricter market discipline** on the existing enterprise sector in order to accelerate its restructuring and productivity growth at the micro level
- **Encouraging the expansion** of both new and fully restructured traditional firms that have proved to be quite competitive without state support.

#### **Impose stricter market discipline**

71. The main strategy that the government should follow for disciplining traditional enterprises could be summarized as follows:

- **Restructuring and drastically downsizing the existing system of state support to the real sector,** including strengthening discipline in the financial sector through the discontinuation of regular recapitalization of state-owned banks and winding down directed credit programs and moving the residual quasi-fiscal activities from the banking sector to the budget. This would help sustain the fiscal balance under lower statutory tax rates. Moreover, this would improve the incentives for enterprise restructuring and would equalize business conditions among different types of business entities.
- **Accelerating the exit of non-viable firms.** A shift toward a more pro-business economic policy in Belarus should employ at least some highly visible cases of the bankruptcy and liquidation of non-viable large enterprises. Such liquidations would be important to support several other improvements. First, they would send a signal to the entire real sector and thus would have a significant incentive effect. Second, they would bring about some additional fiscal savings. Third, they would release economic resources for new firms.
- **Taking additional steps in the agriculture and food processing sector to harden the budget constraint.** These steps would include: (i) the elimination of implicit subsidies, especially those that are allocated through distorted input prices; (ii) better targeting of government support toward more efficient farms and the equalizing of access to state support between private and state farms; (iii) a more aggressive reduction in capacity in food processing; and (iv) a more cautious approach toward merging profitable and non-profitable farms. In the last case, at the very least, the managers of consolidated farms should be allowed to implement appropriate rationalization strategies. There is also a clear need to ensure that the transfers from state-controlled farms to the household sector are carried out with greater transparency.
- **Ensuring further strengthening of the financial viability and efficiency of the energy sector companies.** While some progress has been made in this area in recent years, more is needed to ensure that these companies are on a commercially sustainable footing and thus could meet a growing commercial demand for energy in a cost-efficient way. Specifically, the following policies should be seen as priorities in the sector: (i) completing the phasing-out of implicit subsidies through proper tariff adjustments; (ii) restructuring the existing stock of debt obligations, both external and internal; and (iii) diversifying electricity import.
- **Initiating the preparation of a pilot program of large-scale privatizations** to cover several efficient SOEs (including state banks), which could be privatized competitively in an orderly and transparent way.

- **Pursuing further trade liberalization and the exposure of local producers to international competition.** These measures are critical to strengthen the effects of market discipline on enterprise restructuring and productivity growth. The government should greatly reduce the existing non-tariff restrictions on imports and should phase out the restrictions on trade with Russia that are inconsistent with the Custom Union agreements.
- **Advancing the government's international integration efforts in the direction of both the WTO and the CIS.** The experience of other transition economies suggests that trade negotiations, especially those on WTO membership, could become an important driver for a number of domestic reforms. The government should be prepared to advance its trade negotiations by reducing the current level of subsidization in agriculture and industry, including exporters. In addition, much more progress is needed in liberalizing and demopolizing a number of sectors such as financial services and telecommunications.

### **Encourage new business growth**

72. **The competitiveness of the Belarusian economy is greatly constrained by unnecessary business costs** associated with the current government policies. The economy is also affected by depressed new entry that undermines its flexibility as well as its capability to withstand potential shocks. There is an urgent need for policy adjustments in the following primary directions:

- **Reducing the tax burden and reforming the tax structure.** The priority is to reduce the incidence of the most distortive taxes, such as turnover and payroll taxes. The latter would create additional incentives to accelerate the pension reform that may include an increase in the retirement age. The existing implicit taxes on the industrial sector should be phased out as well. This would require steps to advance the divestiture of enterprises' social assets, to eliminate tariff cross-subsidization in utilities, and provision of agricultural inputs at fixed low prices.
- **Liberalizing employment and wage policies.** Enterprise managers need more decision making powers on labor and wage issues, while at the same time the government should discard its use of administrative controls to attain wage increase targets. Combining this policy with a renewed impetus to support new market entry would limit its potential negative effects on overall employment.
- **Advancing price liberalization** by phasing out the residual price controls, including downsizing the list of enterprises that are subject to price control as monopolists, as well as the list of regulated export prices. This also includes further liberalization of interest rates. In agriculture, producer price levels need to be brought much more into line with international prices. In an economy that has been increasingly internationally integrated, the government could rely on competition as a primary tool for avoiding excessive price growth.
- **Reducing the level of day-to-day regulatory costs.** By launching a more efficient dialogue with the business community, the government should be able to identify and reduce various unnecessary costs that stem from inefficiencies in the regulatory regime. The priority areas for action may include: (i) reforming the tax administration to make the system simpler, more stable and more predictable; (ii) halting the recent trend toward deterioration in the customs administration, which includes addressing the issue of customs valuation practices; (iii) liberalizing the procedures for new entry (by reducing the time needed for business registration and simplifying the procedures); (iv) reducing informal market protectionism and trade barriers at the regional level; and (v) consolidating the tariff schedule.

- **Limiting discretionary administrative interference.** The government needs to change the incentive system for the regulatory agencies to discourage their discretion in enforcing regulatory requirements. Among other things, this means a drastic reduction in "unplanned tax inspections" and similar interventions, which are most detrimental to the business climate. In agriculture, able managers of state-controlled farms should be given much greater decision-making autonomy. Also, businessmen should be offered an independent channel to the central administration to report irregularities in regulatory interventions. The government could accomplish this without a fundamental overhaul of the underlying system of regulations.
- **Accelerating reform in the standards system.** Although the necessary legislative framework is mainly in place, slow reform implementation has not permitted a switch from the excessive compulsory regulation inherent in the ex-Soviet GOST system to the modern two-tiered system of internationally compatible mandatory technical regulations and voluntary standards.
- **Consolidating the recent progress toward a stable macroeconomic environment,** including tightening monetary conditions to lower inflation and taking additional measures to scale down government interventions in the economy (including quasi-fiscal activities) and thus lower government financing requirements and interest rates. Sustained macroeconomic stability is critical to strengthening enterprise incentives for restructuring and investment.

73. **The government must also put considerable resources into improving the country's investment image if it is serious about attracting sizeable foreign investments.** As a starting point, the government should undertake several highly visible decisions to address the most common concerns of the private sector. For example, the golden share rule should either be abolished or as a minimum, the existing legislation should be modified in line with international experience. Its future application should be legally restricted to a narrow set of cases that directly relate to the strategic interests of the state. It would also be advisable to establish a specialized institution for investment promotion, which would employ best international practices in this area and could support a broad communication campaign to develop the country's image as an attractive location for business and investment.

74. **Attracting foreign investment is of special importance for the future rehabilitation and modernization of the energy sector.** Over the next decade, the sector will be facing a growing demand for investments that probably cannot be met internally. In order to secure external financing, the energy sector structure and governance arrangements should be adjusted through structural and institutional transformations such as unbundling the existing monopolies, introducing disclosure and corporate governance principles, and developing public-private partnerships. Establishing an independent regulatory agency and investing in its capacity building would make the sector more attractive to external investors, while it would also help to promote both improvements in energy efficiency and a better quality service delivery.

75. **Belarus also has an opportunity to maximize the benefits associated with its role as an energy transit country.** In order to ensure the sustainable expansion of its transit business, Belarus must convince Russia that it represents a reliable and preferable route for oil and gas exports to Europe. To achieve this, Belarus will need to address the existing reputational issues and to provide for additional investments by securing commercial borrowing and/or considering options for entering into a joint venture or consortium arrangement with Russia and/or Russia's European natural gas customer(s).

76. **The food processing industry is a sector that should become a major beneficiary of FDI.** The development of export-oriented food processing requires substantial investment to underpin efficiency and, most important, to ensure adequate product quality. At the same time, experience elsewhere has shown that modernization and efficiency improvements in primary agriculture can occur quickly once they are driven aggressively by a modernized and internationally competitive processing sector.

#### CONCLUSION

77. The analysis in this report has documented a significant and broad-based growth while pointing to the erosion of several important factors that have driven this growth recently. The Belarusian economy is facing a considerable risk of declining competitiveness. To sustain growth, a significant policy adjustment is necessary to enhance market discipline and encourage new business entry.

78. The following matrix summarizes the results of the analysis in this report and its recommendations. It links the main domestic and external factors that have supported recent growth in Belarus with the emerging risks (which undermine the impact of these factors) and the policy recommendations to address these risks.

**Summary of the Report's Analysis and Recommendations**

<b>Growth factors</b>	<b>Risks</b>	<b>Indicators</b>	<b>Policy Recommendations</b>
<b>I. Domestic factors</b>			
1. Preservation of inherited industrial base and infrastructure	<ul style="list-style-type: none"> <li>- Domestic savings are insufficient for modernization of the existing industrial base</li> <li>- Profits are low, which limits opportunities for investments and modernization</li> <li>- The country's poor investment image limits new entry (including foreign), which deprives the economy of many benefits related to innovation and flexibility</li> </ul>	<ul style="list-style-type: none"> <li>- Depreciation of fixed capital is high, including in export-oriented sectors</li> <li>- Investment-savings gap is considerable and widening</li> <li>- Low level of FDI</li> <li>- Declining share of capital and high-skilled labor intensive goods in exports</li> <li>- Low profitability</li> </ul>	<ul style="list-style-type: none"> <li>- Raising savings by reducing the deficit and strengthening the banking sector</li> <li>- Increasing fiscal transparency and reducing the scope of quasi-fiscal operations</li> <li>- Reducing costs of doing business to raise competitiveness and productivity</li> <li>- Addressing problems of the country's investment image</li> <li>- More active FDI promotion, including through a better utilization of FEZs (Chinese experience)</li> </ul>
2. Advancing macroeconomic stabilization	<ul style="list-style-type: none"> <li>- Low international reserves in the context of no access to international capital markets could cause problems with the balance of payments</li> <li>- High concentration of both taxes and export proceeds – the economy is too dependent on the operations of a limited number of exporters, which in turn makes their markets heavily concentrated</li> <li>- Limited new entry makes the economy inflexible</li> <li>- Viability of the banking sector is undermined by the high incidence of directed lending</li> <li>- The pension system is incapable of supporting the current level of benefits in the future</li> </ul>	<ul style="list-style-type: none"> <li>- Low forex reserves</li> <li>- High concentration of exports and taxes</li> <li>- Projected deficit of the Social Protection Fund</li> </ul>	<ul style="list-style-type: none"> <li>- Further progress toward a stable macroeconomic environment, including tightening monetary conditions and minimizing the fiscal deficit</li> <li>- Efforts to diversify export, including through FDI attraction</li> <li>- Phasing out directed credits</li> <li>- Launching pension reform</li> <li>- Further steps to strengthen financial viability of the energy sector</li> <li>- Strengthening financial discipline in the financial sector</li> </ul>

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3. Fiscal, wage and employment policies aimed at growth in domestic demand	<ul style="list-style-type: none"> <li>- Excessive labor cost growth undermines competitiveness</li> <li>- Income policy aimed at artificially low income differentiation may facilitate emigration of entrepreneurial and educated youth</li> </ul>	<ul style="list-style-type: none"> <li>- ULC growth is high</li> <li>- Share of labor costs in total production costs is growing</li> <li>- Strong interest in emigration among youth; brain drain</li> </ul>	<ul style="list-style-type: none"> <li>- Liberalizing wage and employment policies</li> <li>- Reducing rates of payroll taxation</li> </ul>
4. Subsidies to leading domestic exporters	<ul style="list-style-type: none"> <li>- The current level of subsidization is too high. It creates too much risk for both fiscal and banking systems</li> <li>- Too many recipients of state support. This undermines incentives for restructuring and innovation.</li> <li>- Belarus will have to reduce its level of subsidization as a part of its own WTO accession process. The latter cannot be postponed for too long because of associated costs related to potential economic isolation</li> <li>- Russia may be reluctant to support the existing asymmetry in trade regimes.</li> </ul>	<ul style="list-style-type: none"> <li>- High level of subsidies as percent of GDP</li> <li>- High share of large industrial enterprises that receive state support</li> <li>- High tax burden</li> <li>- Increasing pressure on the banking system</li> </ul>	<ul style="list-style-type: none"> <li>- Simultaneous reduction in the level of subsidization and taxation burden</li> <li>- Reducing government interventions in the credit markets to improve access to financing for non-connected firms</li> <li>- Reducing regulatory costs of doing business in Belarus and facilitating new entry</li> <li>- Advancing price and labor market liberalization</li> </ul>
5. Restriction on imports, especially of consumer goods	<ul style="list-style-type: none"> <li>- Intensive use of non-tariff instruments to discourage consumer imports, some of which violate the Customs Union agreement</li> <li>- Different tax treatment of domestic and imported goods is not compatible with the WTO rules</li> <li>- Non-reforming of the trade regime poses a risk of deepening the country's international isolation</li> </ul>	<ul style="list-style-type: none"> <li>- Share of consumer imports in both private consumption and total imports is low</li> </ul>	<ul style="list-style-type: none"> <li>- Reducing non-tariff barriers for trade</li> <li>- Unifying tax rates (sales tax) for local and imported goods</li> </ul>

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**II. Russia-related factors**

6. Cost and other market advantages in the Russian market	<ul style="list-style-type: none"> <li>- Costs are driven up by the wage policy, taxes higher than Russia's, more expensive credit, and high costs of doing business</li> <li>- Russian economy is too oil-dependent and thus is fundamentally risky as the primary export market</li> <li>- The economy shows difficulties in accelerating export diversification – it would be a problem to re-direct exports to other markets if necessary</li> </ul>	<ul style="list-style-type: none"> <li>- Unit labor costs in Belarusian industry have been growing faster than in Russia</li> <li>- Increased competitive pressures in the Russian market, including from Russian producers</li> <li>- The values of trade diversification indices are low</li> <li>- Indicators of costs of doing business show that Belarusian business faces considerable disadvantages</li> </ul>	<ul style="list-style-type: none"> <li>- Addressing primary factors that undermine competitiveness – high growth in labor costs, high tax burden, high interest rates, and high costs of doing business due to excessive administrative interventions</li> </ul>
7. Preferential access to the Russian market	<ul style="list-style-type: none"> <li>- Russia's WTO accession would make its trade regime and policies much more transparent and would level the playing field</li> <li>- Failure to finalize the currency union with Russia and other integration initiatives</li> </ul>	<ul style="list-style-type: none"> <li>- The Belarusian share of the Russian market for its key export products is declining</li> <li>- Ukraine is catching up in its machinery exports to Russia</li> </ul>	<ul style="list-style-type: none"> <li>- Securing longer term benefits of cooperation with Russia, which are based on the Union Treaty</li> <li>- Avoiding policies that are inconsistent with the Customs Union agreement</li> <li>- Advancing trade diversification, primarily toward the EU</li> </ul>
8. Russian energy subsidies and other transfers	<ul style="list-style-type: none"> <li>- Excessive energy dependence on Russia</li> <li>- Russian domestic and export prices for gas and power are expected to grow</li> <li>- Discussion about gas prices creates political tensions that might affect further economic integration</li> </ul>	<ul style="list-style-type: none"> <li>- Growth in import prices of gas</li> <li>- Reduction in Russian energy subsidies</li> </ul>	<ul style="list-style-type: none"> <li>- Maximizing benefits from being a transit country for Russian oil and gas</li> <li>- Ensuring adequate financing for expansion of transit capacity</li> </ul>

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### III. Other external factors

9. Benefits from the favorable external environment	<ul style="list-style-type: none"> <li>- Oil and other commodity prices will not remain high forever</li> <li>- Belarus' external market position is rather fragile – it depends too much on a limited number of large exporters, which in turn depends too much on a single market</li> <li>- If the Belarusian economy fails to restructure, it will lose its market share in Russia and elsewhere</li> </ul>	<ul style="list-style-type: none"> <li>- Terms-of-Trade index has been favorable for Belarus and especially for Russia</li> <li>- Share of largest exporters and main export goods is too high</li> <li>- Export diversification is too low</li> </ul>	<ul style="list-style-type: none"> <li>- Advancing global and regional trade integration</li> <li>- Reforming policies (subsidization and import restrictions) that may hamper trade integration</li> <li>- Accelerating WTO-compliant regulatory reforms, including in standards and customs administration</li> </ul>
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